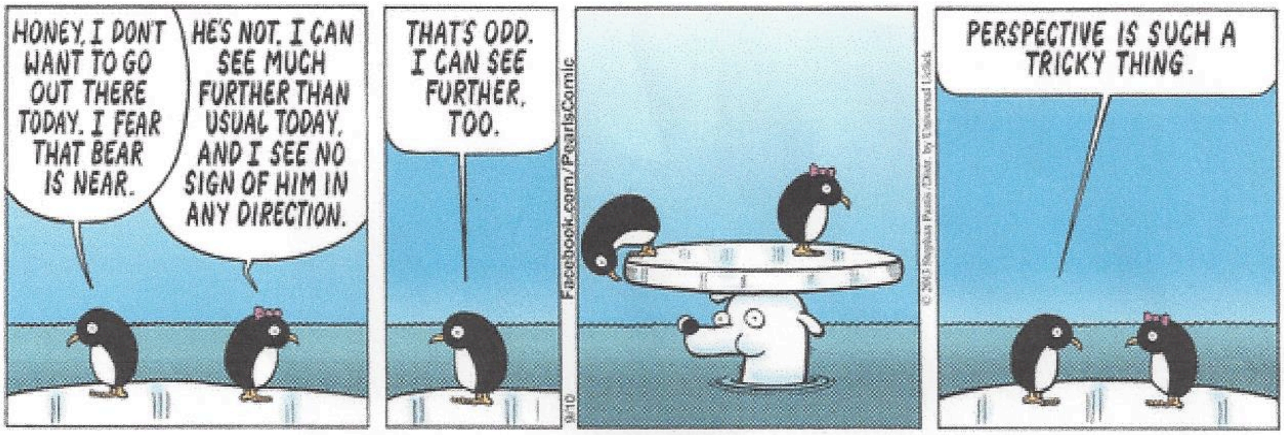

PERCEPTION MEETS REALITY

The economy is alive. Philadelphia Federal Reserve research confirms a Conference Board survey: rising in 34 states, falling in 9 and steady in 7. The focus by the popular press, of course, tends to be on the negative – it sells papers and feeds the mass obsession with conspiracy theories – the ubiquitous "them".

The elegance of business cycles like the current one is their consistency. No, they are not perfectly identical, but how people behave, how they respond to the economy around them and at what time in the cycle, is particularly consistent.

So, what is a business cycle? Popularly defined and in the shortest form possible, its an economy that moves from growth to recession and back again . . . and again. In growth we see wages rise, unemployment fall, sales and earnings rising for most companies and, of course, greater tax revenue to the government.

As growth ebbs, wages tend to stagnate, fewer new hires occur, corporate sales tend to flatten out or even fall year-over-year and, of course, corporate earnings follow sales down. Many variations occur. In this last Great Recession we saw corporate profits, for example, expand sharply along with profit margins on very weak sales – fairly unique only for its magnitude but not in and of itself. Bottom-line earnings growth far exceeded top-line salesgrowth. This semi-odd event made business cycle sense when you consider the enormous cost cutting that occurred – mostly labor – and the very little investing done in new plants, new equipment and the like. Having no confidence in the future, firms maximized the present.

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The perception of it being unique was erroneous. That perception came from comparing it to prior business cycles where the magnitude was less and expectations of better times was very much alive – and that has been clearly missing for some time. In short, context matters. Here's an example:

> Some people think Chris Davies of the Baltimore Orioles is chasing the "true" single season home-run record set by Roger Maris in 1961. These people maintain that the 73 home runs hit by Barry Bonds in 2001 deserve an asterisk because he allegedly used steroids to do it. Funny though, in 1961, everyone thought Maris' chase deserved an asterisk because he had 162 games to break Ruth's record which was set in 154 games. But now, Maris' 1961 is pure? What goes on here? Context, folks, it's all context.

We view the years through the window of age and context. If you are 30ish, the last five have been stunning, unique and hopeless. If you are 70ish, they have been stunning, unique and hopeless. The difference is, of course, that for the young there is no contextual yardstick and for the old the yardstick changed – radically.

For the old, business cycles rarely had financial crashes and massive Fed intervention as simultaneous overlays. Cycles were understood, sort of, had a place in memory and were dealt with. They were expected, tolerated, understood. This time the old used that original "in context" to a point and then lost faith when the new aspect of financial collapse became widely known. (Oddly, the generation that preceded today's old would have understood today quite well).

Major structural changes, like excess credit or global economies or new and massive emerging economies or an activist Fed at prior unseen levels, all render forecasts near impossible if they are not included. To be included, of course, the trick is to identify them. Easier said than done.

So, you say, doesn't that view make the expectation of a "normal" business cycle moot? I don't think so. What doesn't change is the behavior of people over time. We still overdo expectations, still believe trends will continue, still assume no sun in the blackest of nights. We still make decisions about our money, our time and our future based on what we personally "know." We anchor to prior experience; forecast that tomorrow will be like today.

Let's look at a cycle as commonly perceived and in very broad terms:

1) early in any recovery (we begin at some "bottom") inventories are depleted having been run down by producers slowing their output to reflect reduced demand;
2) unemployment is high, but likely stabilizing there;
3) prices are also fairly stable if not weak;
4) optimism by consumers and business is low;

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5) early signs of recovery appear in a pickup in housing – it's traditionally an "early" indicator because mortgage rates are usually low and prices are soft – housing inventory is hard to reduce quickly;
6) with empty shelves, producers begin to produce, mainly for inventory, but in the expectation of a recovering economy (this time we had 2 false inventory starts);
7) housing, depressed in sales and prices for lack of demand, now draws more buyers – a few at first, based on expectations of bargains – and need, too, because households continue to form, people marry, move, etc.;
8) unemployment starts to fall as inventory building begins and producers add small numbers of workers to meet the wholesale and other intermediate goods movers;
9) consumers, somewhat more solvent, begin to buy a few more things, providing positive feedback to manufacturers, but new buying is mostly around basic goods;
10) manufacturers, seeing an uptick in demand begin, at the margin, to consider some new equipment, new plants, etc. and maybe some overtime or part-time help;
11) production and inventories grow with new demand, common stocks rise;
12) prices begin to rise because of higher labor costs and because they can (so-called pricing power in a few areas – food, utilities, loans);
13) unemployment continues to fall, stocks rise further;
14) profit growth expands and stocks forecast higher GDP (not the other way around), GDP rises;
15) materials, industrials and consumer stocks now begin to outperform housing and things like food stocks; these defensive investments give way to discretionary items;
16) industries discretionarily driven begin to do better: technology (both consumer and business), health care (yes, discretionary), financials, particularly banks (loan growth), cars, etc.

Through this build up to an expanding economy, side risks and benefits abound. Improved worker productivity occurs, but so does excess supply – think fiber optic cable or the belief that car unit sales of 18+ million from now on were "likely." Optimism moves to center stage.

Overlay this simplistic business cycle flow with but one new wild card and you get to today. Add easy money – excessive, cheap, credit. I repeat . . . excessive to the point of criminal. Add "you, too, can own a home." Add government spending two times the rate of government income. In short, add credit to the 16-odd points above – see what it does to each in terms of a typical business cycle. This magnifying effect caused downstream magnification: If you thought home prices and volume were making new records you would likely borrow (cheaply, no less) and join the parade. If, as a manufacturer, you were seeing record orders for your goods and you could pay more or add staff with a bit of borrowing (being nearly forced on you by your local bank), you would act. If you were a bank trying to stay in the top quartile of profitability so your officers could earn bonuses, you would make loans at the edge of logic because the world had entered a higher growth phase according to your in-house economist. If you are a union leader and see record profits, you ask management for more of a share.

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The perception for the period from roughly 2000 to 2007, was one of a new era. Credit fueled the philosophy that everyone should own a home while the reality was whether they could pay for it. Homebuilders prospered. Using home equity to buy a third car gave the perception of a very healthy auto industry and the downstream magnifying took care of the suppliers, dealers and the rest. The reality was consumers moved home equity to corporate revenue, leaving themselves in debt.

Labor enjoyed a surplus of jobs; work was available at near all skill levels and the perception became one of entitlement, bigger future pensions, expected raises or bonuses. Management paid itself larger bonuses for little more than reacting to excess demand, be it for loans, products or services.

Of course, stocks of the firms involved rose, often well in advance of their "typical" time in the business cycle.

The end perception was that the business cycle, if not gone, had at least been "smoothed out" such that only a few industries, at widely different times, had slowdowns. Overall, it was all of us oblivious to reality.

The crash, generally attributed to Wall Street's creation of endless new financial products to capture the benefits of this new, smoother cycle, hit the funds providers, the banks, hardest. When the bank was both the source of the funds and the new product creator, it got very ugly.

Perception gave way to reality. There was, in fact, a business cycle under all the happy times and, in fact, it was highly volatile because of all the easy credit. All the normal phases had been magnified to such a degree that reality was lost. A few saw it, but with the financial industry crowded with folks well under 40, poorly schooled in any history and heavily trained in math, it was only a matter of time before their perception, too, gave way to hard reality.

We now find ourselves trying to recover from excess personal debt, high unemployment caused by a major collapse in demand and, of course, much abbreviated discretionary income now that the home equity piggy bank is empty.

The panic of 2008 is still playing out. Our attempts since 2008 to trigger a recovery has relied on the false premise that pouring more money on the problem would fix it. In fact, that easy money flowed around the globe creating excesses most everywhere and extending the false business cycle to many other nations. Oddly, older citizens here went the other direction and paid down debt – or maybe not so odd.

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Many nations, in many ways, bought into a "new era" of smooth growth and rising markets. Much of the emerging countries' growth came from the same illness – excess credit easily created when perception was that all was, would be and must be, okay.

Many, myself included, believe the cure – more money – is far more damaging than the disease. Yes, at the onset systemic failure was probable but, like morphine for initial pain, the Fed put the economy on a permanent drip. Today, tapering off the money drug is significantly harder and, in fact, I have come to believe QE is permanent. Many other solutions were ignored and we find ourselves addicted with little to show for it.

The road out will take years and I'm not sure the Fed, under Yellen, has the courage to make hard calls. I'm of the view that it will be 2017 before we collectively sense any feeling of relief. Weak growth periods are before us as the persistent but distorted business cycle sorts winners from losers and sorts out the excesses. Fully 90% of the American public made it through, sort of, leaving a large number permanently behind. When (or if) we ever consistently run 4.0% real GDP numbers, marginal jobs will be available, but not before. The perception of a typical business cycle just down the road is, regrettably, not yet the reality because the Fed remains all theory with no accountability. Janet Yellen, as W. B. Hunt (Epsilon Theory) puts it, is someone we expect to be in the kitchen making cookies and not making the hard calls as a Larry Summers would. Hunt views her as a consensus builder when we need, he contends, a Napoleon. Hard to disagree.

Globally, a new middle class is coming into being and business cycles will be their fate, too. Domestically, however, and for the next decade or more, we face the demographic bulge of the boomers retiring and bringing with them lower growth. At the moment, they are dominant in the consumer sector and will remain so – they have money. They are living longer and one could envision their bulge being around for 20 or so years. But they don't form new households, buy multiple cars or a second iPhone. They do need medical, dental and care-giver support. A different kind of business cycle, with different end demand lies before us, but a cycle it will remain. Take, for instance, the emphasis placed on the labor force participation rate: Has it occurred to others that the people over 65 – a group 80% larger today than 5 years ago – may well explain a lot of the lower number of people actually working out of the total number of workers available? I suspect if you are still breathing you are an "available worker".

So, what to do? I think that if one accepts that a business cycle still exists it gets a little easier to see down the road. In practical terms I think we may safely use the normal cycle as a very rough guide to the current one. For example, there is much talk about housing of late. We recall that housing is generally an "early" recovery sector. That seems to be the case again as the initial recovery burst has softened. We saw, for another example, that consumers bought only what was needed at the bottom of the cycle and this was evidenced by the strong stock performance of food and utility shares. There was also a yield factor this cycle – investors hunting for income found it, too, in those defensive stocks as they frequently pay high dividends.

Of late, for yet another example of a cycle at work, we note the defensive stocks giving way to better performance of more consumer discretionary stocks – travel, cars, large appliances, electronics and the like. Inventories also behaved much as they have in the past. You may recall that we had run inventories down very low during the Great Recession – few manufacturers or wholesalers wanted to produce or carry stock when the demand for goods was still falling. This time, however, inventories gave many a head fake – two times the producers thought things had turned up and began stocking up for expected new demand – and two times were disappointed. This was a twist on the normal cycle that caught many, but it eventually proved true.

My outlook becomes one of sorting through the various components of a business cycle looking for what may delay or enhance the next phase, including the demographic bubble, and who might be the winners and losers. I accept that it will be fragile, this long recovery, and likely creating new bubbles, some of which are already visible. I expect to hear further emphasis placed on the ineptness of our government to deal with spending issues – and without resolution. I expect yet more QE, yet more attempts to raise taxes to pay for, at the moment, social welfare, but ultimately to simply pay the bills. Through it, though, people remain fairly predictable under circumstances familiar to them and the largest factor is confidence. In this cycle, with improved balance sheets and some pent-up demand, the trigger element is not credit but confidence.

Tools are available to delay any serious reckoning with our long-term debt and social cost issues and the current perception is we will use all of them. Even that perception, thankfully, shows early signs of changing as the man on the street now talks about being concerned about things such as government debt, political failure and social failure. The cycle runs beneath all this – it marches to its own tune tempered in magnitude by the consumer and government climates of trust, confidence and, above all, truth.

Superficial knowledge and the subsequent advice from poorly informed people about our serious problems continues unabated, however, keeping them tools of the panic mongers. Truth, in any modest degree, requires thinking, reading, analyzing, digging for a kernel here, an insight there. Truth is work, truth is complicated, truth is gray. Simplemindedness is not truth. I expect more "survival" mentality to come from the simpleminded, an approach that, by itself, aggravates real issues. What I am suggesting is that many ways out exist without destroying the nation in the process – or simply assuming it will be destroyed. Reality is that in <u>all</u> environments, all cycles, some survive – be it firms, nations or individuals. The irony of the "Armageddon is imminent" crowd is that if they are right, there will be no value or point to their current actions – a topic unto itself.

We've been here before, with wage and price controls in 1971, Penn Square Bank closed by regulators in 1982, the run on Continental Bank in 1984, Nixon abandoning the gold standard, becoming a debtor nation in 1985, the market crash of 1987, the Orange County, California bankruptcy in 1994, our intervention to save the Yen in 1998 – the list is endless. Burying our heads in the sand – the perception that the path out is both easy, clear and will be done by "someone" – is as naïve as the theme that it's totally hopeless. Reality is that we are a nation with an attitude that nothing is impossible. Reality is that the darn cycle – of life, of economics, of change, persists. I suspect the doomsday crowd simply hasn't made the effort to understand that. Knowing cycles is, of course, not the whole answer, but without a sense of it the future would obviously look bleak – and that, too, is not a new or recent discovery. History, say many, may not repeat, but it sure does rhyme.

Cycles continue to provide crude guidelines. Some will be ugly, some will be near invisible. There will be bubbles. The good news is in two parts: We, as a nation, are older and wiser by experience and many more voices are calling for the ever so obvious changes. As my mentor, George Berkaw, would say, "Act appropriately."

October 2013